No. 16,092

In the United States Court of Appeals for the Ninth Circuit

STEVEN VOLOUDAKIS and KATHERINE VOLOUDAKIS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 23-39) are reported at 29 T.C. 1101.

JURISDICTION

The petition for review (R. 40-43) involves deficiencies in federal income taxes and additions to tax for the years 1949 to 1953 inclusive in the following amounts (R. 40):

Year	Deficiency	Additions to Tax Sec. 291(a)	Sec. 294(d) (1) (A)	Sec. 294(d) (1) (B)	Sec. 294(d) (2)
1949	$1,868.66	$ 467.16	.....	$ 4.00	$ 145.95
1950	3,241.66	.....	$387.47	.....	258.31
1951	3,635.80	.....	.....	52.50	261.78
1952	4,093.68	1,023.44	.....	75.00	254.63
1953	5,899.84	.....	.....	97.50	397.64
	$18,739.64	$1,490.60	$387.47	$229.00	$1,318.31

Taxpayers' income tax returns for the years 1949 to 1953 inclusive were filed with the Director of Internal Revenue for the District of Oregon. On February 21, 1956, the District Director mailed the taxpayers a notice of deficiency in the total amount of $18,739.64, plus additions to tax totalling $3,425.38. (R. 7-17.) On the ninetieth day thereafter and on May 21, 1956, taxpayers filed a petition with the Tax Court for a redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 3-17.) The decision of the Tax Court was entered March 18, 1958. (R. 39-40.) The case is brought to this Court by a petition for review filed June 11, 1958. (R. 40-43.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Did amounts received by the taxpayers during the taxable years under the terms of a lease agreement constitute proceeds from the sale of a leasehold resulting in long-term capital gain under Section 117(j) of the Internal Revenue Code of 1939, as

contended by the taxpayers, or were such proceeds ordinary rental income taxable under Section 22(a) of the Internal Revenue Code of 1939, as held by the Tax Court?

2. Where taxpayers filed no declaration of estimated tax for 1950 and failed to pay installments due on declarations of tax filed for the years 1949, 1951, 1952 and 1953, were penalties correctly imposed under Section 294(d) (1) (A) and (B) of the Internal Revenue Code of 1939 and also under Section 294(d) (2) for substantial underestimation of estimated tax for the same taxable years?

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and Regulations are printed in the Appendix, *infra.*

STATEMENT

A portion of the facts was stipulated. (R. 19-23.) The findings of the Tax Court (R. 24-32) may be summarized as follows:

During the years in issue, taxpayers, as partners, owned a dry-cleaning establishment doing business as Stevens Cleaners and Hatters. In addition, the taxpayer husband also owned 99.6 per cent of the outstanding stock of Stevens Cleaners, Inc., an Oregon corporation engaged in the dry-cleaning and used clothing business. Prior to 1946, he conducted his cleaning, dyeing, and laundry operations at 1334 S. W. Morrison Street, Portland, Oregon, occupying approximately one-eighth of the premises known as the Sweeny Building or the Sweeny Block. (R. 25.)

On March 5, 1946, taxpayers executed a lease with the Sweeny Investment Company (hereinafter referred to as Sweeny), owner of the Sweeny Building, for the entire premises comprising the Sweeny Block, subject only to a prior lease to Robert Pantley of a portion of the premises. The lease to Robert Pantley had approximately 6 months to run. The lease executed by Sweeny and taxpayers was for a term of 10 years commencing with the surrender of the premises by all previous tenants except Robert Pantley. The rental provided in the lease was $1,600 per month, payable on the first day of each calendar month. The lease contained the standard provisions normally appearing in leases of business property concerning such matters as the maintenance and alteration of the premises, the liability of the lessee for negligence, destruction of the premises, insurance, assignment and subletting, etc. Taxpayers occupied the entire premises pursuant to the lease of March 5, 1946, made certain improvements on the property and operated a cleaning establishment there for approximately 1 year. (R. 25-26.)

Meanwhile, Pacific Telephone and Telegram Company (hereafter referred to as Pacific) was attempting to locate available office space in the downtown Portland area, and retained Churchill Cook, a realtor, as its agent for this purpose. Churchill Cook contacted the taxpayer husband regarding the need of Pacific for additional space and negotiations for the entire Sweeny Block ensued. On January 17, 1947, the taxpayer husband signed and sent the following letter to Cook (R. 26-28):

Reference is made to our current conversation relative to your procuring for me a sub-tenant who will sub-lease the entire premises known as the Sweeney Block, said premises being further described as the one story building situated on Lots numbered 1 to 8 inclusive in Block South half (S ½) of K in Portland, Oregon, and on which premises I hold a lease expiring in May 1956.

In connection therewith, I agree to vacate and to sub-lease the entire premises in an "as is" condition for the full term of my lease at and for a gross rental at the rate of $50,000 per year, which rental is to be paid in monthly installments of 1/12th each month, beginning with the date that the premises are vacated by the undersigned, which will be sixty (60) days from the date of the execution of the lease.

It is further agreed that your prospective tenant at the time of executing said lease will deposit with me the sum of $35,000.00, which deposit shall represent a partial payment of rent in the amount of $1500.00 per month for the first 24 months of said lease. While an advance rental at the rate of $1500.00 per month would equal the sum of $36,000.00, the $35,000 so paid represents this amount less $1000.00 interest deducted therefrom for the usage of same. The balance of the rental due during the first 24 month shall be paid in monthly installments of $2666.00.

I further agree to vacate 75% of the entire premises within sixty (60) days after the date of the execution of said lease and further agree that the remaining 25% of said premises will be vacated not later than July 30th, 1947.

This agreement shall be valid until February 28th, 1947 in order to permit you and your principals time to accomplish the necessary arrangements to conclude the sub-lease.

This agreement is predicated on the understanding that your principals have viewed the property, have expressed their interest in subleasing said premises and that the proposed sub-tenant is a national concern rated at better than One million dollars.

It is further understood and agreed that whereas the undersigned entered into a lease of the above mentioned property in March, 1946, with the Sweeney Investment Company, a corporation and it is provided in said lease that the same shall not be sub-let or assigned without the written consent of the lessor, Sweeney Investment Company; that this agreement is made contingent upon getting such consent; and if the undersigned is not able to secure said consent, or if the lessor refuses to give its written consent, this entire agreement shall be null and void; and it is further understood and agreed that the parties to whom the undersigned sublets or assigns their rights in the lease to this property will, in occupying and using said property, comply with and assume the obligations of the undersigned regarding the occupancy and use of said property, as contained in said lease from the Sweeney Investment Company to undersigned.

The foregoing letter was drafted by Churchill Cook for the purpose of committing taxpayers to an offer. (R. 28.) On April 7, 1947, the taxpayers signed and sent the following letter, drafted by Churchill Cook, to Pacific (R. 28-29):

> Reference is made to our lease agreement wherein you are leasing the entire one story building situated on Block (S ½) "K" in Portland, Oregon.
>
> In connection therewith and with specific attention to the advance rental in the amount of $35,000, to be paid at the time of consummating this lease, please be advised this will authorize and request you to pay directly to G. C. Cook the sum of $10,500 from the advance rent to be paid me at that time, said payment to G. C. Cook being payment in full for his services in connection therewith.

Negotiations between the parties culminated on April 8, 1947, with the consent of Sweeny, the original lessor, as required by the lease executed March 5, 1946, and with the execution of a three-way agreement by Sweeny, Pacific, and taxpayers. The agreement, dated April 8, 1947, was for a term of 9 years (the remainder of the unexpired term under the lease of March 5, 1946) commencing with the surrender of 70 per cent of the premises. The rental to be paid by Pacific was $50,000 per year, payable monthly at the rate of $1,900 to Sweeny and $2,266.67 to taxpayers. (R. 29.) The agreement describes taxpayers as lessors and Pacific as lessee, and contains the following provisions (R. 29-30):

> WHEREAS, the Lessee desires to lease said premises;
>
> NOW, THEREFORE, for and in consideration of the covenants and agreements of the parties hereto as hereinafter set forth, it is hereby agreed as follows:

> 1. The Lessors hereby lease to the Lessee all of the property above described for a term of nine (9) years commencing on the date when possession of at least seventy per cent of said premises is delivered to the Lessee, which date shall be not later than May 1, 1947. * * *
>
> * * * *
>
> 22. If the Lessee shall fail to pay any rent or other payments provided for in this lease, or if the Lessee shall default in the performance of any of its covenants in this lease, and if such default is not remedied within thirty (30) days after written notice thereof, Lessors without further notice or demand may enter upon and repossess the premises and expet [*sic*] the Lessee and those claiming under it and remove its effects without being deemed guilty of trespass and without prejudice to any remedies which may be used for arrears of rent or preceding breach of covenant.

In accordance with the provisions of the foregoing agreement the premises were vacated by taxpayers and possession was taken by Pacific. The agreement expired by its terms on or about May 1, 1956. Pacific negotiated a new lease directly with Sweeny for possession of the premises after May 1, 1956. (R. 30.)

The payments made by Pacific to taxpayers under the agreement of April 8, 1947, aggregated $237,130.41. The amounts received by taxpayers under the agreement of April 8, 1947, were reported by taxpayers on their partnership returns as long-term capital gains resulting from an installment sale, with the following explanation of the transaction appended (R. 30-31):

On April 8, 1947, taxpayer entered into an agreement with the Pacific Telephone and Telegraph Company, whereby the company would purchase the taxpayer's interest in the property leased by the taxpayer from Sweeney Investment Co., Spokane, Washington. Taxpayer had previously entered into a lease on March 1, 1946 for a period of ten years with Sweeney Investment Co. for the property which was now made available to the Pacific Telephone and Telegraph Co., for a total price of $237,130.41 which payments are to be made by that company to the taxpayer from April 8, 1948 to March 6, 1956. This transaction constitutes a sale of the original lease with the profit being reported on the installment plan as less than 30% of the sales price was received during the initial year 1947.

The amounts reported by taxpayer as payments received from Pacific during the years in issue were as follows (R. 31):

Year	Amount received	Gain as computed on returns	Taken into account on joint return, 50 per cent as long-term capital gains
1949	$21,200.04	$16,785.21	$ 8,392.60
1950	27,200.04	21,535.73	10,767.86
1951	27,200.04	21,535.73	10,767.87
1952	27,200.04	21,535.73	10,767.87
1953	27,200.04	21,641.99	10,821.00

The Commissioner determined that the foregoing amounts represented rental income rather than proceeds of an installment sale of taxpayers' leasehold, and allowed amortization of certain leasehold improvements and of commissions and legal fees. (R. 31.) The Commissioner accordingly determined tax-

payers' net rental income for each of the years in issue to be as follows (R. 32):

Year	Gross rent received	Allowable amortization	Net rent
1949	$21,200.04	$5,063.15	$16,136.89
1950	27,200.04	5,063.15	22,136.89
1951	27,200.04	5,063.15	22,136.89
1952	27,200.04	5,063.15	22,136.89
1953	27,200.04	5,063.15	22,136.89

The Tax Court held that the agreement of April 8, 1947, was a sublease and not an assignment, and therefore that the payments received were taxable as ordinary income under Section 22(a) of the Internal Revenue Code of 1939 rather than as capital gain under Code Section 177(j). (R. 32-38.) The Tax Court also held that the Commissioner properly imposed additions to tax under both Sections 294(d)(1) and (2) for the same years. (R. 38-39.)

SUMMARY OF ARGUMENT

1. The Tax Court correctly held that amounts received by taxpayers during the taxable years 1949-1953 constituted rentals taxable as ordinary income under Section 22(a) of the Internal Revenue Code of 1939 and not proceeds from the sale of a leasehold taxable as capital gain under Code Section 117(j). Whether a transaction is a lease or a sale is determined by the intention of the parties to the instrument, and the courts will look to this intent to determine the legal effect of the transaction. Here the intention of the parties as expressed in the plain and unambiguous language of the instrument was to lease

and not to sell. The instrument recognized the continuing existence of the earlier 10-year lease to the taxpayers, repeatedly referred to the payments to taxpayers as rental, referred to taxpayers as lessors and to Pacific as the lessee. Taxpayers retained the right of re-entry for default by the lessee of any covenant in the lease, a provision entirely consistent with a landlord and tenant relationship. Under the instrument in question the lessee assumed an entirely different obligation with respect to the amount of rental payments than taxpayers had assumed under the earlier lease. Taxpayers did not testify that they intended a sale, only that the transaction involved a vacation of the premises. Correspondence before execution of the lease in question confirms an intent to lease rather than sell. No intention is shown anywhere in the record to substitute the sublessee for the taxpayers in the earlier lease so as to effect an assignment.

Even assuming as taxpayers contend that the agreement in question effected a termination of their interest and substitution of Pacific as lessees, that would not render the transaction a "sale". As this Court recently held (*Leh* v. *Commissioner*, decided October 17, 1958), a surrender of a contractual right is not a "sale" for capital gain purposes.

The facts of the instant case are distinguishable from those in cases where a lessee sells, transfers or relinquishes leasehold rights for a stated consideration, under a written instrument showing an intention to transfer or sell a lessee's rights absolutely. The common law principle is inapplicable here that where a lessee transfers all of his rights and obliga-

tions under a lease for the remaining time of the lease the transfer is regarded as an assignment rather than a sublease. In the first place, the record is not conclusive that taxpayers did transfer the entire unexpired term of their original lease. The expiration date of the earlier 10 year lease does not coincide with the 9-year lease involved here. Moreover, even if taxpayers had transferred the entire term of their lease, that in itself would not create a sale where, as here, the record shows a clear intention to lease rather than sell. Inasmuch as the record shows that the payments were intended to be rental payments, they are fully taxable as ordinary income under Section 22(a) of the Internal Revenue Code of 1939 rather than at capital gains rates.

2. The Tax Court properly held that taxpayers were subject to additions to tax for substantial underestimation of estimated tax under Section 294(d)(2) of the Internal Revenue Code of 1939 as well as to additions to tax under Code Sections 291(a), and 294(d)(1)(A) and (B). That more than one addition to tax may be imposed for the same taxable year has been decided by this Court and by at least two other Circuit Courts. Moreover, there is no merit to the contention that the additions to tax for substantial underestimation should be excused because of alleged good faith. That penalty is not subject to a reasonable cause limitation, or to any other defense. The language of the Code sections involved, the legislative history of their enactment and the applicable Treasury Regulations all show a clear intent that the several additions to tax may be imposed for the same taxable year.

ARGUMENT

I

The Tax Court Correctly Held That Amounts Received By Taxpayers During The Taxable Years Constituted Rentals Taxable As Ordinary Income Under Section 22(a) Of The Internal Revenue Code Of 1939 And Not Proceeds From The Sale Of A Leasehold Taxable As Capital Gain Under Code Section 117(j)

The principal issue in this case is whether certain payments to taxpayers in 1949 to 1953 under the lease agreement of April 8, 1947, constituted rental payments taxable as ordinary income under Section 22(a) of the Internal Revenue Code of 1939 (Appendix, *infra*), as the Tax Court held (R. 32-38) or whether these payments were proceeds of a sale by taxpayers of their leasehold, taxable at capital gains rates under Code Section 117(j) (Appendix, *infra*), as taxpayers contend (Br. 12-28). It is submitted that the Tax Court correctly held that these payments were rental payments, fully taxable as ordinary income in the years involved.

Section 22(a) of the 1939 Code defines gross income as including, among other things, all income from "sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, * * * or gains or profits and income derived from any source whatever". Whether a particular transaction is a lease or a sale is determined by the intention of the parties to the instrument, and the courts will look at this intent to determine the legal effect of the transaction. *Haggard* v. *Commissioner*, 241 F. 2d 288 (C.A. 9th); *Oesterreich* v. *Commis-*

sioner, 226 F. 2d 798 (C.A. 9th); *Watson* v. *Commissioner*, 62 F. 2d 35 (C.A. 9th). As the Court stated in its *Oesterreich* opinion, *supra*, p. 803, "The intention of the parties, as expressed in the instrument, was cardinal * * *. In construing a written lease, the intent of the parties must be gathered from an examination of the whole instrument, and a construction should be given, if at all possible, which will render all clauses harmonious so as to carry into effect the actual purpose and intention of the parties. *Buck* v. *Mueller*, 207 Ore. 169, 293 P. 2d 736, certiorari denied, 352 U.S. 895.

Here, looking at the instrument of April 8, 1947, as well as all other circumstances disclosed in the record bearing on the parties' intent, the instrument (Ex. 2-B, R. 20, 68) was exactly what it purported to be—a lease. It recites clearly that taxpayers were the owners of a leasehold interest, recognizing the continuing existence of the ten-year lease between taxpayers and Sweeny executed the previous year (Ex. 1-A, R. 19-20, 68). It repeatedly refers to the payments from Pacific to taxpayers as "rental", stating that the rental was payable to the taxpayers monthly from the date possession of 70% of the premises was delivered, but not later than May 1, 1947, for nine years thereafter. There are numerous references to "this lease", to taxpayers as "Lessors" and to Pacific as "Lessee", paragraph 1 beginning, "The Lessors hereby lease to the Lessee all of the property above described for a term of nine (9) years * * *". Thus the language of the agreement points to the execution of a lease, and not to a sale. The language used in the instrument is plain and unam-

biguous, and shows that the parties recognized that the original lease continued in existence for the duration of its term. There is a complete lack of any language in the instrument or circumstance in the record tending to show that taxpayers were selling their leasehold or that they or Pacific intended a sale. By paragraph 22 taxpayers retained the right of reentry for a default by the lessee of any of the covenants in the lease, with the provision that if the default was not remedied within 30 days after written notice the taxpayers as lessors could enter and repossess the premises and expel the lessee. As the Tax Court pointed out (R. 34), this provision is entirely consistent with a landlord and tenant relationship.

Under the April 1947 agreement the lessee assumed entirely different obligations with respect to the amount of rental payments than taxpayers had assumed under the 1946 lease. Moreover, the original lease had required taxpayers as lessees to carry public liability insurance for the benefit of Sweeny, whereas the 1947 lease did not require the lessee to carry similar insurance. Under paragraph 21 of the 1947 lease, Pacific incurred an obligation relating to possible increases in property taxes, an obligation not assumed by the taxpayers under the original lease. Paragraph 6 of the 1947 lease recognized the continuing obligation of taxpayers to carry fire insurance on the property. There is nothing in form or substance to indicate that the earlier lease was being *assigned* to Pacific. Voloudakis did not testify that he intended a sale. His testimony was vague and unresponsive,

and the most he could say, when asked if he thought he was selling something to Pacific, was that the transaction was "Just vacate my premises". (R. 51.) Merely vacating the premises does not, of course, operate *per se* to make the transaction a sale, for the surrender of possession is as much an incident of a lease or sub-lease as it is of a sale or exchange.

In the negotiations preceding the lease, the intention of the parties to lease rather than sell was also made clear. In his letter of January 17, 1947 (Ex. N, R. 26-28, 54, 68), Voloudakis offered Churchill Cook "to vacate and to sub-lease the entire premises in an 'as is' condition for the full term of my lease at and for a gross rental at the rate of $50,000 per year, which rental is to be paid in monthly installments of 1/12th each month, * * *"; and in taxpayers' letter of April 7, 1947, to Pacific (Ex. O, R. 28-29, 56, 68) they referred to "our lease agreement wherein you are leasing the entire one story building * * *" and suggested the payment of "advance rental" of $35,000 in consideration of which the lease stated (paragraph 2(c)) the lessee "shall be entitled to a credit upon the amount of rental accruing to Voloudakis of Fifteen Hundred Dollars ($1500) per month during the first twenty-four months of this agreement." From this correspondence it is obvious that taxpayers intended at all times to create a relationship of landlord and tenant with Pacific, and not to sell their leasehold interest.

There is nothing in the record to indicate that the parties to the April 8, 1947, agreement did or intended to eliminate taxpayers and to substitute

Sweeny in their place so as to effect an assignment of the 1946 lease. In the absence of anything in the record to show that the parties intended the contract to be a sale, the Tax Court was clearly correct in concluding that it was simply what it purported to be, a subleasing of the premises from taxpayers to Pacific.

Taxpayers rely on cases holding that payments received by a lessee in return from the cancellation or surrender of a leasehold interest are considered as being for the "sale" of a capital asset and may be reported as capital gain rather than ordinary income. See *Commissioner* v. *McCue Bros. & Drummond, Inc.*, 210 F. 2d 752 (C.A. 2d), certiorari denied, 348 U.S. 829; *Commissioner* v. *Ray*, 210 F. 2d 390 (C.A. 5th), certiorari denied, 348 U.S. 829; *Commissioner* v. *Golonsky*, 200 F. 2d 72 (C.A. 3d), certiorari denied, 345 U.S. 939; *Sutliff* v. *Commissioner*, 46 B.T.A. 466, but see *Leh* v. *Commissioner*, decided October 17, 1958 (2 A.F.T.R. 2d 5960). However, as the Tax Court pointed out (R. 32-36) those cases are clearly distinguishable from the instant case. In each of those cases there was a clear intention that the lessee sell, transfer or convey leasehold rights for a stated consideration under a written instrument which showed the intention of the parties was absolutely to transfer or sell the lessee's rights to the leasehold. As has been shown, there is nothing in the record here to show such an intention. Moreover, in those cases the consideration received by the lessee for the sale of the leasehold interest was in the form of a lump sum payment, whereas here the tax-

payers received rental payments in equal monthly installments over a 9-year period. Also cf. *Beus* v. *Commissioner* (C.A. 9th), decided November 3, 1958 (2 A.F.T.R. 2d 6134); *Commissioner* v. *Remer* (C.A. 8th), decided November 5, 1958 (2 A.F.T.R. 2d 6034); *Waller* v. *Commissioner*, 40 F. 2d 892 (C.A. 5th), certiorari denied, 282 U.S. 889; and *Robinson* v. *Elliot* (Mont.), decided October 31, 1957, pending on appeal to C.A. 9th, Nos. 15,983 and 15,784.

Taxpayers rely on the principle that at common law where a lessee transferred all of his rights and obligations under a lease for the remaining time of the lease, and retained no reversionary interest the transfer was regarded as an assignment rather than a sublease. (Br. 12-20.) That principle, however, has no application here. In the first place, there is no showing in the rceord that taxpayers did transfer the entire unexpired term of their original lease. There is evidence that the 1947 lease expired May 1, 1956, but no evidence as to the beginning date and hence the expiration date of the 1946 lease. Admittedly the 1946 lease provided for a term of 10 years, but the term was not to begin until the day when former tenants of Sweeny vacated the premises, a date not ascertainable from the evidence. According to the evidence, a 60-day notice to vacate was served on at lease one of the tenants, and Voloudakis admitted in his testimony that the former tenants of Sweeny continued in possession of their space "until their time was up. They had about a six months lease." (R. 63.) There was no other evidence adduced in respect to the beginning date of the 1946

lease, and it is impossible, therefore, to determine when the term ended. The best estimate, in view of the evidence, is that the 10 year term of the 1946 lease would not have expired much sooner than August or September of 1956, which does not coincide with the 9 year term of the 1947 lease admittedly expiring on May 1, 1956. The evidence refutes rather than supports the contention that the taxpayers leased the whole unexpired term to Pacific.

Other evidence possibly bearing on this point, namely, the explanation given by the taxpayers when reporting the payments received under the lease of April 8, 1947, adds to the confusion. According to this evidence, the payments to be received under the lease aggregated $237,130.41, the so-called "contract price" (Ex. 8-H to 12-L, inclusive, R. 22, 30-31, 68). On this basis, using the schedule of monthly payments under the lease, the last payment seems to fall on or about February 1, 1956, which leaves the interval from that date to May 1, 1956, the admitted expiration date of the lease, unexplained in the record.

However, assuming that taxpayers did transfer the entire term of their lease to Pacific, that in itself does not create an assignment where, as here, the facts and circumstances clearly show a sublease was intended. See *Douglas Properties, Inc.* v. *Commissioner*, 21 B.T.A. 347. Although admitting that there is no Oregon case squarely in point, taxpayers rely on Oregon cases (Br. 16-19) for the principle that, when one other than a lessee is in possession of leased premises, it is presumed that the lease has been

assigned to him. This presumption, however, can be rebutted where, as here, the intention of the parties is clearly to sublease rather than to sell. See *Quine* v. *Sconce*, 209 Ore. 486, 306 P. 2d 420. This Court so held in *Northwestern Mut. Life Ins. Co.* v. *Security S. & T. Co.*, 261 Fed. 575. Moreover, there is no merit to taxpayers' attempt to discredit the Tax Court for allegedly incorrectly relying on the case of *Moline* v. *Portland Brewing Co.*, 73 Ore. 532, 144 Pac. 572. Whether or not an *assigning* lessee remains liable to the landlord for rent or for the performance of any of the covenants of a lease is not before this Court, and the Tax Court's statement with respect thereto was only dictum. In the instant case, the parties did not eliminate the taxpayers and substitute Sweeny in their place as in an assignment, and taxpayers remained liable on their 1946 lease during its term.

The intention of the parties as shown by the record is clear that the payments here in question were rental payments, and not proceeds from the sale of taxpayers' leasehold, and, therefore, that the payments were fully taxable as ordinary income under Section 22(a) of the Internal Revenue Code of 1939 rather than at capital gains rates.

In any event, even assuming as taxpayers contend (Br. 11, 19-20) that the tripartite agreement had the effect of completely terminating taxpayers' interest and substituting Pacific as lessee, it still would not follow (as taxpayers further assume) that the transaction must be viewed as a "sale or exchange" for capital gain purposes. As this Court recently held in a case involving a similar issue (*Leh* v. *Com-*

missioner, decided October 17, 1958 (2 A.F.T.R. 2d 5960), the surrender or elimination of a contractual right by a taxpayer is not tantamount to a "sale", so as to entitle the taxpayer to treat the consideration received for the surrender as capital gain. In the words of this Court in the *Leh* case, the "principal object, result and 'effect' [of the transaction] was to terminate rights, not continue them, nor transfer them—nor sell them—nor exchange them." See also *Commissioner* v. *Pittston Co.*, 252 F. 2d 344 (C.A. 2d), certiorari denied, 357 U.S. 919. Moreover, as the Tax Court noted (R. 35-36), the instant case presents an *a fortiorari* situation for denying preferential capital gain treatment to the consideration received, since the consideration was here received as "rental" over a period of many years rather than in a lump sum in a single taxable year. The capital gain provisions of the taxing statute were designed to afford relief in cases where appreciation in the value of a capital asset over a number of years is realized in a single taxable year, by way of a sale or exchange of the asset, and they are to be strictly construed. See *Burnet* v. *Harmel*, 287 U.S. 103, 106; *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265. This is not such a case.

II

The Tax Court Properly Held That Taxpayers Were Subject To Penalties For Substantial Underestimation Of Estimated Tax Under Section 294(d) (2) Of The Internal Revenue Code Of 1939

Taxpayers' returns for 1949 and 1952 were not filed in time, and additions to tax for those years

were assessed under Section 291(a) of the Internal Revenue Code of 1939. They did not file a declaration of estimated tax for the year 1950, and consequently the Commissioner assessed an addition to tax for that year under Code Section 294(d)(1)(A) (Appendix, *infra*). Moreover, they failed to pay installments due on the declarations of estimated tax filed for 1949, and 1951-1953, within the time prescribed by law, and additions were assessed under Code Section 294(d)(1)(B) (Appendix, *infra*), for those years. (R. 9, 24.) The taxpayers do not contest the imposition of these penalties, but contend (Br. 28) that the assessment of additions to tax under Section 294(d)(2) for substantial underestimation of tax for 1949-53 (R. 9, 24) was improperly sustained by the Tax Court (R. 38-40).

Taxpayers apparently argue, first, that it was erroneous to assess additions under both Code Section 294(d)(1) and (2); and, second, that they should be excused from additions for substantial underestimation in any event because the underestimation was made in good faith. It is submitted that neither argument has merit.

That both additions to tax may be imposed for the same taxable year was recently decided by this Court in *Hansen* v. *Commissioner*, 258 F. 2d 585, certiorari pending on another issue, which is controlling here; see also *Erwin* v. *Granquist*, (Ore.), decided May 10, 1957 (1957 P-H, par. 72,786, affirmed *per curiam*, 253 F. 2d 26 (C.A. 9th); *Patchen* v. *Commissioner*, 258 F. 2d 544 (C.A. 5th); *Abbott* v. *Commissioner*, 253 F. 2d 537 (C.A. 3d); *Kaltreider*

v. *Commissioner*, 255 F. 2d 833 (C.A. 3d); *Fuller* v. *Commissioner*, 20 T.C. 308, affirmed on other issues, 213 F. 2d 102 (C.A. 10th); see Treasury Regulations 118, Section 39.294-1(b) (3) (a) (Appendix, *infra*); S. Rep. No. 221, 78th Cong., 1st Sess., p. 42 (1943 Cum. Bull. 1283, 1345); H. Conference Rep. No. 510, 78th Cong., 1st Sess., p. 56 (1943 Cum. Bull. 1351, 1372); cf. *Acker* v. *Commissioner*, 258 F. 2d 568 (C.A. 6th), rehearing denied, September 3, 1958 (2 A.F.T.R. 5658), petition for certiorari pending.

Contrary to taxpayers' contention (Br. 28), there is nothing in the language of Code Section 294(d) (2) which would excuse a taxpayer from additions to tax for substantial underestimation because of alleged good faith. Similar contentions were rejected in *Kaltreider* v. *Commissioner*, *supra; Clark* v. *Commissioner*, 253 F. 2d 745 (C.A. 3d); and *Bouche* v. *Commissioner*, 18 T.C. 144; see also *Patchen* v. *Commissioner*, *supra*. As the Third Circuit stated in *Kaltreider* v. *Commissioner*, *supra* (p. 839):

> The penalty for substantial underestimation of estimated tax under Section 294(d) (2) is not subject to a reasonable cause limitation, nor indeed to any other defense.

We submit that in sustaining the additions to tax the Tax Court was fully in accord with the language of Section 294(d) (1) and (2), with the legislative history of the section's enactment, and with the applicable Treasury Regulations, all of which show a clear intent that the several additions to tax may be imposed for the same taxable year.

CONCLUSION

For the reasons stated, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [as amended by Sec. 210(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906] [1] *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of

[1] The provisions of Section 117(a)(1) of the Internal Revenue Code of 1939 prior to this amendment, applicable for the taxable years 1949 and 1950, are substantially the same.

the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business;

* * * *

(j) [as added by Sec. 151(b) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than six months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * *

(26 U.S.C. 1952 ed., Sec. 117.)

SEC. 294 [As amended by Section 118(a), Revenue Act of 1943, c. 63, 58 Stat. 21; Sections 6(b)

(8), and 13(b) of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231; Section 2, Act of January 2, 1951, c. 1195, 64 Stat. 1136; and Section 103(b), Revenue Act of 1951, c. 521, 65 Stat. 452]. ADDITIONS TO THE TAX IN CASE OF NONPAYMENT.

(d) *Income Tax.*—

(1) *Failure to file declaration or pay installment of estimated tax.*—

(A) *Failure to File Declaration.*—In the case of a failure to make and file a declaration of estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of each installment due but unpaid, and in addition, with respect to each such installment due but unpaid, 1 per centum of the unpaid amount thereof for each month (except the first) or fraction thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subgaragraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment. For the purposes of this subparagraph the amount and due date of each installment shall be the same as if a declaration had been filed within the time prescribed showing an estimated tax equal to the correct tax reduced by the credits under sections 32 and 35.

(B) *Failure to Pay Installments of Estimated Tax Declared.* — Where a declaration of estimated tax has been made and filed within the time prescribed or where a declaration of estimated tax has been made and filed after the time prescribed and the Commissioner has found that failure to make and file such declaration within the time prescribed was due to reasonable cause and not to willful neglect, in the case of a failure to pay an installment of the estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of the unpaid amount of such installment, and in addition 1 per centum of such unpaid amount for each month (except the first) or fraction thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subparagraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment.

(2) *Substantial underestimate of estimated tax.*—If 80 per centum of the tax (determined without regard to the tax (determined without regard to the credits under sections 32 and 35), in the case of individuals other than farmers exercising an election under section 60(a), or 66⅔

per centum of such tax so determined in the case of such farmers, exceeds the estimated tax (increased by such credits), there shall be added to the tax an amount equal to such excess, or equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax so increased, whichever is the lesser. This paragraph shall not apply to the taxable year in which falls the death of the taxpayer, nor, under regulations prescribed by the Commissioner with the approval of the Secretary, shall it apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter (excluding, in case the taxable year begins in 1943, any quarter beginning prior to July 1, 1943) of such year (or in the case of farmers exercising an election under section 60(a), within the last quarter) in an amount at least as great as though computed (under such regulations) on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of the filing of the declaration for such taxable year (or in the case of any such farmer, or in case the fifteenth day of the third month of the taxable year occurs after July 1, on July 1 of the taxable year) but otherwise on the basis of the facts shown on his return for the preceding taxable year. In the case of taxable years beginning prior to October 1, 1950, and ending after September 30, 1950, the additions to tax prescribed by this subsection shall not be applicable if the taxpayer failed to meet

the 80 per centum and 66⅔ per centum requirements of this paragraph by reason of the increase in normal tax and surtax on individuals imposed by section 101 of the Revenue Act of 1950. In the case of taxable years beginning prior to November 1, 1951, and ending after October 31, 1951, the additions to tax prescribed by this subsection shall not be applicable if the taxpayer failed to meet the requirements of this paragraph by reason of the increase in rates of tax on individuals imposed by the Revenue Act of 1951.

(26 U.S.C. 1952 ed., Sec. 294.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

Sec. 39.294-1 [2] *Additions to the tax.*—

* * * *

(b) *Additions for specific failures on the part of the taxpayer with respect to the estimated tax*—

* * * *

(3) *Substantial understatement of estimated tax.* (1) Section 294(d)(2) provides for an addition to the tax in the case of a taxpayer who makes a substantial underestimate of tax on his declaration. Such addition to the tax shall not apply to the taxable year in which

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[2] The same provision appears in Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939, Section 29.294-1 (b) (3), applicable to the taxable years 1949-1951.

falls the death of the taxpayer. Except as hereinafter provided—

(a) In the case of individuals, other than those exercising the election under section 60(a), relating to farmers, an addition to the tax under section 294(d)(2) is applicable in the event that the amount of the estimated tax (increased by the amount of the credit for taxes withheld at source on wages under section 35 and the credit under section 32) is less than 80 percent of the tax imposed by chapter 1 for the taxable year (determined without regard to such credits). In the event of a failure to file the required declaration, the amount of the estimated tax for the purposes of this provision is zero.

* * * *

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